

## **Advisory Opinion 2000-4**

### **MONTGOMERY COUNTY ETHICS COMMISSION**

#### **ADVISORY OPINION**

This opinion is issued in response to a request from the County Council for guidance on the following questions related to the professional background of applicants for appointment to the Board of Investment Trustees:

Would an individual whose profession is to market, to pension funds and other institutional investors, the kind of investment services purchased by the Board face an inherent conflict of interest in serving as a Board member?

If not, what restrictions on the individual's participation in Board decisions, such as the selection of investment managers and investment consultants, would be necessary to avoid conflicts of interest?

#### **ADVICE**

The Commission is of the opinion that one who furnishes or is employed by a firm that furnishes, to pension funds and other institutional investors, the kind of investment services purchased by the Board (an "investment manager") would not face an inherent conflict of interest in serving as a member of the Board of Investment Trustees. The duties of those persons do not, in and of themselves, present an inevitable conflict of interest. Thus, for example, although the Employee Retirement Income Security Act (ERISA), in recognition of the complex interests of investment advisors and investment managers who act as fiduciaries, prohibits fiduciaries from receiving any personal consideration from any party dealing with the plan in connection with a transaction involving assets of the plan or when other actual conflicts arise, ERISA does not disqualify investment managers per se from serving as trustees of private pension plans. Nevertheless, given the many crossover relationships in today's market among investment managers, financial consultants, and broker/dealers, an investment-manager trustee often may be faced with potentially divided loyalties between his or her obligations as a trustee and some potential benefit or detriment to him or her as a private investment-manager, and the presence of an investment manager on the Board may give rise to divided loyalties and conflicts on the part of fiduciaries with whom the Board contracts or attempts to contract for professional services. Indeed, given the highly competitive nature of this market, the presence on the Board of a trustee who is an investment manager or an employee of an investment manager may have a negative effect on the willingness of competitors to offer proprietary products to the County, since they may be required to make known proprietary information in connection with such offers. Consequently, unless there are no other sufficiently qualified candidates, the Commission recommends that, as a matter of policy, no currently employed investment manager or employee of an investment manager be appointed to the Board.

## APPLICABLE LAW

1. The Board of Investment Trustees Law. Montgomery County has established, by law, a trust for the benefit of the members of the retirement system. The trust consists of the money and property of the retirement system, and all earnings, profits, increments, appreciation, and other additions that accrue thereon, and is administered by a nine-member Board of Investment Trustees that has legal title to all cash and other property of the retirement system. Four of the trustees are ex officio members: the Director of Management and Budget, the Director of Finance, the Director of Human Resources, and the Staff Director of the County Council. The other five trustees, all of whom are appointed by the Executive and confirmed by the Council, must include:

- (1) an active County employee in a collective bargaining unit who is a vested member of the retirement system, or an individual recommended by certain employee organizations;
- (2) an active County employee who is a vested member of the retirement system and the Merit System, and not a member of a collective bargaining unit;
- (3) a retired County employee who is a member of the retirement system;
- (4) a representative of the Council selected from a list of 3 to 5 individuals recommended by the Council; and
- (5) an individual knowledgeable in pensions, investments, or financial matters.

The Board: (1) must invest and reinvest, or cause to be invested or reinvested, the principal and income of the retirement system and keep the same invested without distinction between principal and income; (2) has the exclusive authority to manage the assets of the retirement system; (3) may make or permit an investment manager to make individual investment selections with respect to certain investments and certain personal property, and (4) must select at least three investment managers to make individual investment selections with respect to certain kinds of investments and certain kinds of real property. With certain exceptions, the Board may permit an investment manager to invest the assets of the retirement system fund in any investment the manager considers prudent within policies set by the Board, including but not limited to bonds, debentures, notes, savings accounts, certificates of deposit, variable note arrangements, obligations of the United States Government, commercial paper, money market certificates, bankers' acceptances or other evidence of indebtedness; mortgages, certificates of mortgage pools and guaranteed mortgage pass-through certificates or other similar investments in mortgages; stocks (regardless of class), or other evidence of ownership, in any corporation, mutual fund, investment company, association, or business trust; combined, common or commingled trust funds; retirement or annuity contracts; guaranteed

investment contracts; group annuity contracts; and real and personal property of all kinds, including leaseholds on improved or unimproved real estate, oil, mineral or gas properties, or royalty interests or rights. Subject to certain limitations, the Board may:

- (1) purchase or subscribe for any investment, at a premium or discount, and retain the investment;
- (2) sell, exchange, convey, transfer, lease for any period, pledge, mortgage, grant options, contract with respect to, or otherwise encumber or dispose, at public or private sale, for cash or credit or both, any part of the retirement system;
- (3) sue, defend, compromise, arbitrate, compound and settle any debt, obligation, claim, suit, or legal proceeding involving the retirement system, and reduce the rate of interest on, extent or otherwise modify, foreclose upon default or otherwise enforce any debt, obligation, or claim;
- (4) retain uninvested a part of the retirement system fund;
- (5) exercise any option on any investment for conversion into another investment, exercise any rights to subscribe for additional investments, and make all necessary payments;
- (6) join in, consent to, dissent from, oppose, or deposit in connection "with the reorganization, recapitalization, consolidation, sale, merger, foreclosure, or readjustment of the finances of any corporation or property in which the assets of the retirement system are invested, or the sale, mortgage, pledge or lease of that property or the property of any such corporation upon such terms and conditions that the Board considers prudent; exercise any options, make any agreements or subscriptions, pay any expenses, assessments, or subscriptions, and take any other action in connection with these transactions that the Board considers prudent; and accept and hold any investment that may be issued in or as a result of any such proceeding;
- (7) vote, in person or by any proxy, at any election of any corporation in whose stock the assets of the retirement system are invested, and exercise, personally or by any power of attorney, any right appurtenant to any investment held in the retirement system; and give general or specific proxies or powers of attorney with or without power of substitution;
- (8) sell, either at public or private sale, option to sell, mortgage, lease for a term of years less than or continuing beyond the possible date of the termination of the trust, partition or exchange any real property for such prices and upon such terms as the Board considers prudent, and execute and deliver deeds of conveyance and all assignments, transfers, and other

legal investment for passing the ownership to the purchaser, free and discharged of all liens;

- (9) renew or extend any mortgage, upon such terms that the Board considers prudent, and increase or reduce the rate of interest on any mortgage or modify the terms of any mortgage or of any guarantee as the Board considers prudent to protect the retirement system or preserve the value of the investment; waive any default or enforce any default in a manner that the Board considers prudent; exercise and enforce any right of foreclosure, bid on property in foreclosure, take a deed in lieu of foreclosure with or without paying a consideration, and release the obligation on the bond secured by the mortgage; and exercise and enforce in any action, suit or proceeding at law or in equity any rights or remedies in respect to any mortgage or guarantee.
- (10) form a corporation or corporations under the laws of any jurisdiction or acquire an interest in or otherwise make use of any corporation already formed to invest in and hold title to any property;
- (11) to take any action it considers prudent for the purpose of investing in and holding title to real or personal property or part interests therein;
- (12) incur and pay expenses for agents, financial advisors, actuaries, accountants and counsel, if those expenses are incurred solely to perform the Board's duties under this article;
- (13) borrow, raise or lend moneys, for the purposes of the retirement system, in such amounts and upon such terms and conditions as the Board in its discretion considers prudent; for any money borrowed, issue a promissory note and secure tile repayment of this note by pledging or mortgaging all or any part of the retirement system;
- (14) hold, buy, transfer, surrender, and exercise all other incidents of ownership of any annuity contract;
- (15) buy from any legal reserve life insurance company a single premium, nontransferable annuity contract providing for the payment of the benefits.
- (16) do all acts which it considers necessary and exercise any and all powers with respect to the management of the retirement system, and in general, exercise all powers in the management of the assets which an individual could exercise in the management of property owned in the individual's own right except for making an individual investment selection.

With certain exceptions, the Board must appoint investment managers to manage, acquire, or dispose of assets of the retirement system, subject to Board policies. In any

investment manager contract, the Board must identify the assets that are the subject to the contract and give an investment manager the right to invest the assets of the retirement system specified in the contract without prior notice to or approval by the Board. The Board may limit the investment of a specified portion of the retirement system to a certain type of property, e.g., common stocks, bonds, or real estate, and may delegate to the investment manager any of the Board's powers or discretion and give the investment manager custody and control of certain assets of the retirement system. The Director of Finance is the custodian of the retirement system assets. With the Board's approval, the director may make written contracts with banks, trust companies, insurance companies or investment companies authorized to do business in any state for the safe custody of investments, banking services, the payment of benefits and expenses and all other function necessary for the management and safeguarding of the assets of the retirement system. Contracts may authorize a bank, trust company, insurance company, or investment company to invest retirement system assets in money market funds; a short-term investment fund of a bank, trust company, or insurance company; or their substantial equivalent. The Board's statute sets a standard of care for fiduciaries that applies to the trustees and investment managers, among others:

A fiduciary must discharge the fiduciary's duties regarding the retirement systems: only in the best interest of the participants and their beneficiaries;

- (a) only in the interest of the participants and their beneficiaries;
- (b) only to provide benefits to the participants and their beneficiaries, and defray reasonable expenses of administering the retirement systems.
- (c) with the care, skill, prudence, and diligence under the circumstances that a prudent person acting in a similar capacity and familiar with the same matters would use to conduct a similar enterprise with similar purposes;
- (d) by diversifying the investments of the retirement systems to minimize the risk of large losses, unless it is clearly not prudent to diversify under the circumstances;
- (e) according to a good faith interpretation of the law governing the retirement systems; and
- (f) according to a good faith interpretation of the documents and instruments governing the retirement systems, if they comply with this [Law].

The Board's law also expressly addresses the subjects of ethics and conflicts of interest. Members are subject to the provisions of the Montgomery County Public Ethics law. Furthermore, with certain exceptions, a trustee must not:

- (1) be a party to any transaction engaged in by the Board or an investment manager involving the assets of the retirement system;

- (2) use the gains or profits of the system for any purpose except to make investments or payments that are authorized by the Board;
- (3) deal with the assets of the retirement system for their own interest or account;
- (4) act in any transaction involving the retirement system on behalf of a party whose interests are adverse to the interests of the retirement system or the interests of the members or beneficiaries of the retirement system; or
- (5) become an endorser or surety, or in any manner an obligor, for moneys loaned to or borrowed from the Board.

2. The Montgomery County Ethics Law. Not only does the Board's law expressly subject the Trustees to the provisions of the Ethics law, the Ethics Law expressly treats any person appointed by the County Executive or County Council to a board as a "public employee" for the purposes of that statute. It is clear, therefore, that the prohibitions of the Ethics Law apply to the members of the Board of Trustees. Section 33-61D of the Ethics Law contains a conflict of interest provision that provides, in pertinent part:

- (a) Unless permitted by a waiver, a public employee must not participate in:
  - (1) any matter that affects, in a manner distinct from its effect on the public generally, any:
    - (A) property in which the public employee holds an economic interest;
    - (B) business in which the public employee has an economic interest; or
    - (C) property or business in which a relative has an economic interest, if the public employee knows about the relative's interest:
  - (2) any matter if the public employee knows or reasonably should know that any party to the matter is:
    - (A) any business in which the public employee has an economic interest or is an officer, director, trustee, partner, or employee;
    - (B) any business in which a relative has an economic interest, if the public employee knows about the interest;

- (C) any business with which the public employee is negotiating or has any arrangement about prospective employment;
- (D) any business that is negotiating with a relative or has an arrangement with a relative about prospective employment, if the public employee knows about the negotiations or the arrangement;
- (E) any business or individual that is a party to an existing contract with the public employee or a relative, if the contract could reasonably result in a conflict between private interests and official duties;
- (F) any business that is engaged in a transaction with a County agency if:
  - (i) another business owns a direct interest in the business;
  - (ii) the public employee or a relative has a direct interest in the other business; and
  - (iii) the public employee reasonably should know of both direct interests;

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- (H) any creditor or debtor of the public employee or a relative if the creditor or debtor can directly and substantially affect an economic interest of the public employee or relative.

However, if a disqualification leaves less than a quorum capable of acting, or if the disqualified public employee is required by law to act or is the only person authorized to act, the disqualified public employee may participate or act if he or she discloses the nature and circumstances of the conflict. The Ethics Law also expressly prohibits a public employee from intentionally using the prestige of his or her office for private gain or the gain of another, from using an official County or agency title or insignia in connection with any private enterprise (unless authorized by the Chief Administrative Officer), and from disclosing confidential information relating to or maintained by a County agency that is not available to the public, except when authorized by law, or using confidential information for personal gain or the gain of another. These express prohibitions are to be read and applied in light of the express legislative findings and statement of policy on which the Ethics Law is founded:

- (a) Our system of representative government depends in part on the people maintaining the highest trust in their officials and employees. The people

have a right to public officials and employees who are impartial and use independent judgment.

- (b) The confidence and trust of the people erodes when the conduct of County business is subject to improper influence or even the appearance of improper influence.
- (c) To guard against improper influence, the Council enacts this public ethics law. This law sets comprehensive standards for the conduct of County business and requires public employees to disclose information about their financial affairs.
- (d) The Council intends that this Chapter, except its provisions for criminal sanctions, be liberally construed to accomplish this purpose.

### **APPLICABLE FACTS**

The Commission is advised as follows regarding the applicable facts. The Board of Investment Trustees currently engages twelve investment managers, at a cost of approximately \$5.5 million per fiscal year to manage its approximately \$2 billion in investments. The Board also retains financial advisors and consultants who manage the hiring of investment managers and report to the Board on the performance of the investment managers. In the investment industry, there are many crossover relationships among investment managers, financial consultants, and broker/dealers. As a result, it is difficult to assure that a trustee who is in the business of selling services to pension funds ("an investment-manager trustee") is exercising impartial and independent judgment in Board matters. For example, the Commission understands that it would not be unusual for a Montgomery County trustee who is an investment-manager to find himself or herself working for another pension fund whose financial advisor or consultant is seeking to do business with Montgomery County and could affect significantly the trustee's investment-manager relationship with the other pension fund. So too, a Montgomery trustee who is an investment-manager could easily find that a financial advisor to the Montgomery County Board advises one or more other boards on procurements the trustee's investment-manager firm is interested in obtaining. An investment-manager trustee may have a private interest in voting to support or hire a broker/dealer who gives or could give the investment-manager's firm free brokerage services for other clients, or may have an interest in having a Montgomery County investment-manager use a broker who is on another board that uses the investment-manager trustee's firm. Finally, top investment-manager firms may resist competing for work for Montgomery County out of fear of providing proprietary information to an investment-manager trustee whose firm is competing or may compete for business at another pension fund.

### **CONCLUSION**

The people of Montgomery County "have a right to public officials and employees who are impartial and use independent judgment." Indeed, "our system of representative



government depends in part on maintaining the highest trust in our officials and employees," and "[t]he confidence and trust of the people erodes when the conduct of County business is subject to improper influence or even the appearance of improper influence." For these reasons, the Ethics Law was enacted expressly "[t]o guard against improper influence" and was intended to be "liberally construed" to accomplish that purpose. In addition, under the County pension law a trustee's fiduciary duty of undivided loyalty to the Plan prohibits him or her from engaging in any transaction in which he or she has other business interests or represents parties who have such interests. Consequently, given the numerous relationships or potential relationships between investment-managers and others in the investment industry, the appointment of a trustee who is a day-to-day investment-manager or an employee of an investment-manager may give rise to many problematic situations in which: (1) the trustee may be faced with potentially divided loyalties between his or her fiduciary obligations and some benefit or detriment to his or her firm; (2) the presence of such a member on the Board may give rise to divided loyalties and conflicts on the part of the fiduciaries with whom the Board contracts or attempts to contract for professional services; and (3) major investment-managers may be dissuaded from offering their services to the Board because its members include a representative of a competitor. Therefore, in order to guard against improper influence by avoiding the significant potential for actual or perceived conflicts or divided loyalties in the highly sensitive administration of the County's pension fund, the Commission recommends that the Council not nominate for appointment to the Board of Investment Trustees an individual who furnishes or is employed by a firm that furnishes, to pension funds and other institutional investors, the kind of investment services purchased by the Board.

[signed]

Walter Scheiber, Chair

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